Japan

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **June 20, 2016**

Analyst: Rolf Danielsen. Tel : +46 8 7638392. E-mail: rolf.danielsen@seb.se

Last year's economic performance disappointed across the board and developments so far in 2016 give not much hope for anything better. As a result the VAT hike has been postponed once again this time to 2019. Markets may soon decide "Abenomics" dead but so far continue to regard Japan as safe haven.

Summary and conclusion

Sluggish growth set to continue. Last year proved a disappointment beyond expectations: the economy recovered only 0,6% following a shallow recession in 2014. The current year is again poised for a disappointment with virtually no growth wharsoever. That is despite the upbeat announcement of a 1.9% annualized QoQ growth in the first quarter which however may have been much due to the lack of adjustments for the extra leap year day in the official presentation. As such, expectations are for another year of almost stagnation with government expenditure being the main driving force.

Financial policies set for failure? The economic weakness recently prompted the government to once again postpone the second VAT hike -- the first arrow of "Abenomics" when launched in 2013. That should have set fiscal policies on a path to consolidation mitigating concerns over the growing government debt burden already at 246%/GDP. Should the government soon add another 2%/GDP of fiscal stimulus the debt ratio may start to accelerate. At the same time confidence in monetary easing of the central bank (BoJ) is on the verge of collapse. Once again weakening price pressure could turn into outright deflation. That is in part due to low oil prices but also core inflation has dropped below 1% when it should have reached 2% by now. Abenomics' first two arrows have fallen short of targets. The third has yet to be shot for real.

Unexpected market reactions: But the authorities may be excused inasmuch as international investors have proven extraordinarily unpredictable. Since BoJ opted for negative interest rates in last January on top of its ongoing and aggressive quantitative easing in the hope of stoking inflation through a weaker yen, this has rather appreciated by nearly 10%. Observers talk of a new paradigm: Left with burned fingers from carry–trade investors are rather looking for fundamentals. Here Japan scores with large reserves and a steady trade surplus.

Shoring up external security: The weak economy notwithstanding PM Abe is believed to harbor one ambition above all: to safeguard Japan's future against worsening regional security. For that he needs to change the pacifist clause of the Constitution and before that to win Upper House elections of next month.

Over the last year external ratings have mainly stayed put but last April one agency signaled it would regard any postponement of the second scheduled VAT hike as credit negative. On that point we agree as regards country risk as well in particular in the case of adverse market reactions.

Recent developments

Last year at this time we had predicted rising growth reaching almost 2% in 2016. Unfortunately, that bullish prediction proved baseless. Due to some external factors but mostly domestic ones we now see a stagnant economy that may be about to lose its political guidance of recent years, Abenomics.

Sluggish growth set to continue: A year ago along with market consensus we believed the worst was over and that the economy was set for a moderate recovery after the recession caused by the first VAT hike in 2014. Even though the economy managed a 0,7% pick-up in terms of real GDP, that was only half the expected result. Worse still is the estimated forecast for the current year. From a hopeful 1,8% pick up expected a year ago, activity is now set for virtual stagnation with only 0,1% expansion.

Weak domestic sentiment: While external factors have not remained benign including fear of a hard landing in China continuing to weigh on sentiment of international investors, it is the domestic economy that has hit Japan hardest. Last year, consumer expenditures were down 1,2%, industrial production declined by the same rate, while the little growth that occurred was driven by government and some rise in export demand.

A kick-start to the current year? This year, the economy appeared to have experienced a kick-start, rising 1,9% on a quarterly and seasonally adjusted basis. However, that encouraging result came with two important qualifications. Firstly, growth of the previous quarter, the October-December period of 2015, was significantly adjusted down and secondly, the government had not factored in the effect of the extra working day in February due to the leap year. Correcting for the latter reduced quarterly growth at least by a half and even close to nil according to various private estimates. Trailing investment demand was the main culprit followed by a new drop in private consumption calculated on an annual basis.

Inflation: Where art thou? The first arrow of Abenomics – the economic revival policy of the newly elected PM Shinzo Abe launched in early 2013 -- was to take Japan out of deflation mood and raise actual inflation to 2% a year. This was to be achieved in the face of fiscal contraction as the central bank would aggressively incentivize banks to raise money demand by cutting interest rates and significantly stepping up quantitative easing. In the event this had little effect. The jump in consumer prices of 2,8% in 2014 was mainly the result of the 3pp (percentage points) hike in the VAT from 5% to 8%. In 2015, by contrast, price pressure fell back to only 0,8% and in the first months of the current year it fell flat in a declining trend that will likely leave the consumer price index (CPI) in negative territory for the whole year. Some of that effect, in particular in 2015, stemmed from the sharp drop in global energy prices. That effect should be fading now leaving weak domestic demand as the main contributor to renewed deflation. Also core inflation has been in decline falling below 1% in May which may seem odd against the backdrop of recently achieved full employment.

Tightening labour market: The labour market is the bright spot of recent years' economic development. Unemployment has fallen to 3,2%, below the previously estimated full employment measure of 3,5%. First of all, this is much due to the gradual decline of the working age population steadily falling by almost 1% a year although this effect has been much mitigated by rising participation rates among women and able bodied retirees. They have started to fill jobs in the services sector which are open for temporary workers and now swelling to almost 40% of the total labour market. The main part of the jobs market is for permanent employment – often referred to ass life-time jobs. Here wages are clearly higher than for temporary workers often by a factor of two to three. As a result, many employers are more interested in hiring temporary workers and have subsequently been bidding up their wages. In the main jobs market, by contrast, wages are climbing slowly. This year's "shunto" – the spring salary negotiations for permanent workers – once again showed modest raises as low inflation expectations weighed on the bargaining power of employees.

Rising external surplus: In 2015, the trade surplus widened further as exports continued recent years' gains in terms of receipts measured in US$. That includes growing services exports on the back of rising numbers of tourists from mainland China. However, imports fell steeply, by almost 20%, reflecting not only low global oil prices but also domestic economic weakness. For the current year exports of manufacturing products including autos have been hit by disruptions following the Kumamoto earthquake in last April but are still expected to post some gains while imports will continue weak. As a result the current account surplus could grow further to almost 4%/GDP, up from 3,4% in 2015, which itself was sharply up from the previous year.

Negative capital account balance: In 2015, the surging current account surplus was mainly offset by net capital outflows as seen in overall stable reserves save for minor variations mainly due to valuation affects. The BoJ was not known to interfere with the market determination of the yen through outright interventions. Large outflows continued in the same magnitude as the current account net payment inflows over the foreign direct investment account (FDI) as major Japanese companies continued investing soaring profits abroad. In the event the level of reserves remained very high at about $1,2 trillion, second in the world only to China's and sufficient to pay for some two years of imports. They were also as large as the total of money supply and as such several times above the oft-cited 20% minimum level.

The Bank of Japan (BoJ) -- central bank -- recently pushed back its target for achieving its 2% inflation promise to 2019, three years behind schedule. The announcement was highly predicted and left little impression on markets.

Financial policies

With the failure so far of the BoJ to trigger higher inflation and the government's lack of resolution to rein in the fiscal deficit sufficiently to stabilize its debt, the fear is growing that markets might one day declare Abenomics dead.

PM Abe pushes back the second VAT hike: In early June of the current year, PM Abe announced the highly expected event that the second hike from 8% to 10% on value added (VAT) scheduled for 2017, would be postponed to late 2019. This was the second time the PM balked at the prospects of tax hikes sending the economy into a tailspin. The first time, in 2014, the reactions had been had been a shallow recession and many observers see continued weak consumer demand as a legacy of that decision. One could therefore argue that the economy was in danger of crumbling should such an event take place again.

Rising government deficit: Against that may be argued that at a still high level of almost 7%/GDP the general government deficit is unsustainably high thus keeping the government debt ratio on an upward track. The cancelation of the VAT hike will now add at least 1pp to the budget deficit relative to GDP. Should this be accompanied as rumoured by a supplementary budget of yen 10 trillion following up-coming elections in July, the fiscal expansion for the current and the next year might probably exceed the 9%/GDP deficit recorded in 2012 and thus undo hard-won fiscal austerity of recent years.

Higher growth to the rescue? The hope is of course that such an impetus would trigger economic growth in particular through higher private sector spending. Unfortunately, that cannot be relied on as the Japanese economy has not responded to economic stimuli of recent years in the way one would have expected. Should GDP growth in nominal terms, that is taking account of also inflation, not rise above its less than 1% annual level such a budget deficit could prove destabilizing for government debt dynamics. That is even more so should investors take fear and begin to demand a premium on the yield for buying government bonds. Today this is partly negative for maturity less than 10 years, but should it flip back by an average of only 100bsp across the yield curve, the annual nominal deficit could rise by an additional 2pp.

Are we looking at the wrong debt measure? For most countries there is no big difference between gross and net debt. Japan differs, however, as government agencies often hold large amounts of government bonds (JGB) including pension funds, the nationwide Postal Bank and since 2013, increasingly also the BoJ. Excluding these and other non-private holdings of JGBs, the IMF estimates net government debt at 130% of GDP. While not insignificant, this is still no more than the debt ratio of Italy. Held by government agencies these holdings are ultimately under government control and unlikely to be thrown overboard even in a potential crisis. However, should markets come to regard these holdings as on the verge of default (or at least "unrepayable") then the holders may also be regarded as insolvent with further knock-on effects on their creditors. That includes most banks with potentially immediate effects on their standing in global markets. It also includes present and future retirees with impact on their savings behaviour. The upshot is that it is not obvious that one can analytically net out these agency holdings when assessing the government debt position.

Is Kuroda giving up on the inflation target? The first target date for achieving the 2% annual inflation rate expired already last year and a new date set for 2017 seems hardly more achievable. Even if it were to be reached, it is not obvious that such inflation would have been accompanied by real economic expansion. In the present situation, with a ramp-up of fiscal policies, observers are beginning to mull a new stance of monetary policies that is to maintain a back-stop on possible yen appreciation while also preventing a precipitous drop in the stock market. The latter has soared through the first three years of PM Abe's present term and held up as an ongoing success story despite some fall-back since late 2015. As such, speculations are going high of another rate cut if the US fails to hike its policy rate anytime soon. However, that would meet with growing resistance from banks which are concerned about its profitability and saw its share prices fall abruptly as the BoJ strolled into negative interest rate territory in late January. Also households would stand to suffer from negative rates on their savings.

Aggressive quantitative easing: Quantitative easing has a long history in Japanese monetary policies but has been ramped up aggressively under Abenomics. Under the present program the central bank is buying a net worth of JPY80trillion a year and is already holding JGBs to the tune of almost 40% of GDP. With a rate of expansion at about 17%/GDP on an annual basis it is likely to reach 50% by the end of the current year. Both in terms of dynamics and the level reached so far that significantly exceeds the quantitative easing of either the ECB or the Fed. The total outstanding is somewhat below 200% of GDP but that doesn't mean the BoJ can continue for another 5-10 years.

Is quantitative easing nearing its end? Banks and other financial institutions need JGBs for regulatory and prudential reasons including as collateral for various transactions. Some observers see an end to the central bank's JGB program already next year. In addition it is noted that the central bank's almost daily purchases of government bonds have attracted what may be regarded as unhealthy interest from banks, including foreign banks, which buy new issues in the primary market and can sell them next day to BoJ often with a decent mark-up for minimal risk taking. That could be portrayed as squandering tax-payers money. Some observers are concerned that the monetary authorities will eventually resort to other non-conventional methods including "helicopter money" while others point out that this is in effect what is going on already when the central bank in all but form is financing the total fiscal deficit at an increasingly negative rate of interest.

Structural politics and TPP: Structural policies – the third arrow of Abenomics – may have quietly achieved more results than often recognized. That includes higher participation rates for women and a more flexible labour market as seen in the growth of the temporary jobs slowly crowding out the market for permanent jobs. A milestone would be reached if the Diet (Parliament) as expected soon passes the US initiated TPP agreement for trade and investments among the Pacific countries, not including China though. This will open up more sectors of the Japanese economy to foreign competition currently protected by regulations and tariffs. The destiny of the TPP, however, also depends on the next US President as it is unlikely to pass Congress before elections in November.

Income distribution: Observers point out that Abenomics may have skewed the income distribution in an otherwise relatively egalitarian society and that this may be the reason for its failure. The weaker yen has not done much to lift real household incomes and clearly less so than corporate profits. Corporates, in return, have been more reluctant to share rising profits with their employees than with shareholders who are poorly represented among regular households. As a result, private consumption has remained relatively flat and contributed to sluggish economy. This goes a certain way in supporting the argument that the government and the central bank should rather accept more appreciation if this can be managed in a gradual manner in order to support private consumption and economic growth.

Weak productivity growth: Productivity growth has gradually dropped to only 0,5% on an annual basis. This is a long-standing issue invoking a multitude of explanations. The recent acceleration, though, is most likely related to the new labour market entrants, including unemployed women and retirees, often to service sector jobs where productivity growth is traditionally low.

Politics

LDP infighting: In a country where one party, the Liberal Democratic Party (LDP) has been in government for almost the entire post WW2 period, faction politics can be more important than open party politics. To keep the balance among the various factions to prevent party splits it may be vital to ensure a certain circulation of important posts within government. As a result, with a few important exceptions though, Japanese governments have tended to be short-lived. Mr. Abe has already been Prime Minister for almost four years and must step down or stand for reelection by next year at the latest. That also means there are little prospects of the opposition retuning to power anytime soon.

Amending the Constitution: Speculations are that the incumbent will run again at next general elections to the lower house of the Diet. That is in particular likely unless he is able before that to pass the bill for a constitutional amendment related to Japan's long standing self-imposed and strict self-defence stance. This is a contentious issue with the electorate that could be affected by economic growth and the well-being of households and as such presenting another argument for the PM to support the economy "whatever it takes at this stage".

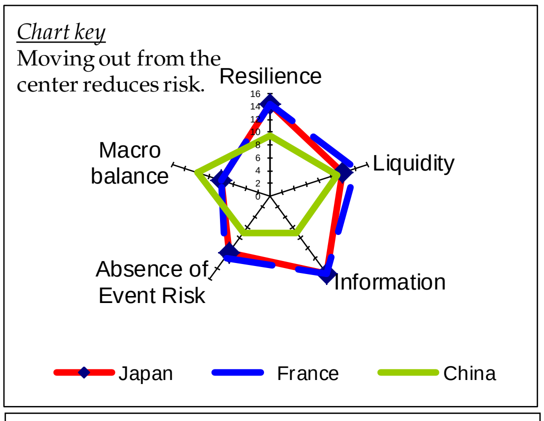
Outlook

On the positive side our outlook for Japan is gradually becoming more skewed to the short term with longer term prospects increasingly in the dark. What may now look like a failure of Abenomics demands an answer to the question: So what -- is there any plan B? At some point it may become increasingly obvious to markets that a completely new tack is needed in terms of uprooting old societal relations and political traditions. Hopefully markets will then be confident this can be accomplished in a smooth manner.

For the near term we foresee more of the same as in the last few years, that is continued very weak growth but also overall stable financial markets. Confidence will remain supported by external economic and financial strengths while growing domestic imbalances, in particular of the government, will remain "behind closed doors". However the recent cancelation of the VAT hike scheduled for 2017 and a possible new fiscal stimulus may quickly set the government debt on a path of unsustainable dynamics.

Markets may still for some years accept this outcome taking succour from the fact that Japan is still a country of remarkable business and a world leader in high tech and manufacturing products. The threat is however, that this balance may become increasingly hostage to negative event risks that would eventually prompt a risk premium on government debt. This might set in motion a vicious circle of dropping asset values with major investors looking to diversify into foreign assets. Even though the foreign assets of the central bank represent a war chest to fight outflows, the process in itself could get out of hand with financial turmoil in its wake. It may be a matter of time before financial markets recognize that at least under present policies Japan is about to reach the end of the rope.

Key ratios	**2016**
Population (mill.)	126.3
GDP/capita ($)	35 449
GDP(% change)	0.1%
Inflation	0.1%
Curr.Acc. Balance/GDP	3.9%
Reserves/imports (months)	43
Budget balance/GDP	-7.7%
Government net debt/GDP	234%



External ratings:
Fitch: A
Moody's: A1
S&P: AA-/neg.

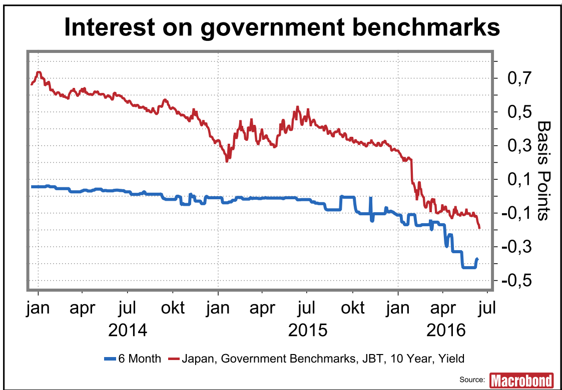
Peers:
USA
France
China

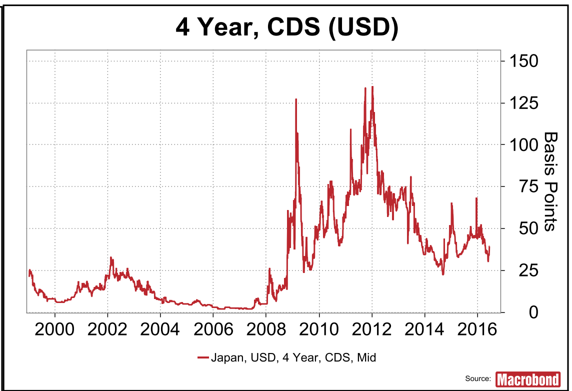
Graph: The graph shows Japan as a strong country with much the same risk profile as France, and much less so with China. Like France, Japan has a weaker macro balance than China, but lower event risks although that is rising gradually..

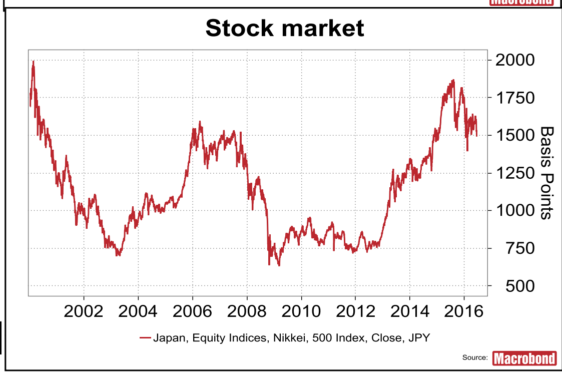
Key data:	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
GDP (bill. US$)	5 925	5 960	4 918	4 608	4 126	4 477	4 233	4 085
GDP/capita (US$)	46 568	46 884	38 736	36 351	32 608	35 449	33 594	32 497
GDP (change)	-0.4%	1.7%	1.4%	-0.1%	0.6%	0.1%	0.4%	0.5%
Investments/GDP	20%	20%	20%	20%	20%	20%	20%	20%
Budget balance/GDP	-8.8%	-8.7%	-8.5%	-7.7%	-6.7%	-7.7%	-6.8%	-6.0%
Govt debt/GDP	205%	212%	218%	223%	227%	234%	240%	244%
CPI inflation (%)	-0.3%	0.0%	0.4%	2.7%	0.8%	0.1%	0.9%	1.0%
Money demand (%)	3%	3%	4%	3%	4%	2%	1%	2%
Stock prices (%change)	821	769	1123	1263				
Interest rates	0%	0%	0%	0%	0%	0%	0%	0%
Exch. Rate ($)	80	80	98	106	121	112	119	125
Trade/GDP (%)	27%	27%	30%	33%	30%	28%	29%	31%
Oil price (Brent)	$111	$112	$109	$99	$52	$42	$50	$60
Billions US $								
Export of goods	788	770	686	693	615	633	621	622
Imports of goods	809	842	794	811	635	616	623	638
Other:	149	134	154	154	155	159	151	143
Current account	**129**	**62**	**46**	**37**	**135**	**176**	**149**	**128**
as % of GDP	2.2%	1.0%	0.9%	0.8%	3.3%	3.9%	3.5%	3.1%
FDI	-118	-117	-145	-118	-131	-139	-132	-127
Loan repayments (MUSD	-258	-281	-255	-260	-257	-267	-265	-260
Net other capital flows (M	341	424	346	357	232	250	262	282
Balance of payments	**93**	**88**	**-8**	**16**	**-21**	**20**	**14**	**23**
Reserves	1 112	1 199	1 192	1 207	1 186	1 207	1 221	1 243
Total debt	2 871	3 126	2 836	2 891	2 851	2 967	2 945	2 890
o/w short term debt	574	625	567	578	570	593	589	578

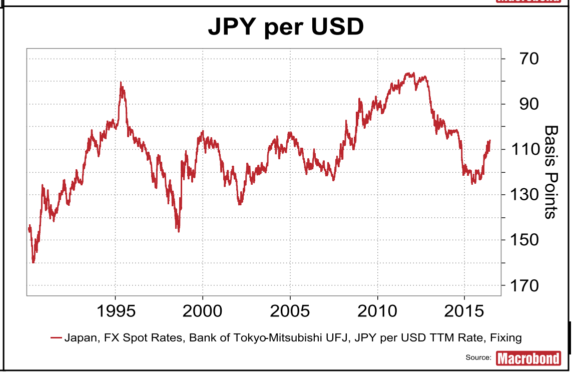
Rating history					
Fitch (eoy)	AA	A+	A+	A+	A
Moodys	Aa3	Aa3	Aa3	A1	A1

Type of government:	Constitutional Monarchy
Next elections	Parliamentary 2016
Other:	
Latest PC deal	None
Latest IMF arrangements	None









Disclaimer

Confidentiality Notice

The information in this document has been compiled by SEB Merchant Banking, a division within Skandinaviska Enskilda Banken AB (publ) ("SEB").

Opinions contained in this report represent the bank's present opinion only and are subject to change without notice. All information contained in this report has been compiled in good faith from sources believed to be reliable. However, no representation or warranty, expressed or implied, is made with respect to the completeness or accuracy of its contents and the information is not to be relied upon as authoritative. Anyone considering taking actions based upon the content of this document is urged to base his or her investment decisions upon such investigations as he or she deems necessary. This document is being provided as information only, and no specific actions are being solicited as a result of it; to the extent permitted by law, no liability whatsoever is accepted for any direct or consequential loss arising from use of this document or its contents.

SEB is a public company incorporated in Stockholm, Sweden, with limited liability. It is a participant at major Nordic and other European Regulated Markets and Multilateral Trading Facilities (as well as some non-European equivalent markets) for trading in financial instruments, such as markets operated by NASDAQ OMX, NYSE Euronext, London Stock Exchange, Deutsche Börse, Swiss Exchanges, Turquoise and Chi-X. SEB is authorized and regulated by Finansinspektionen in Sweden; it is authorized and subject to limited regulation by the Financial Services Authority for the conduct of designated investment business in the UK, and is subject to the provisions of relevant regulators in all other jurisdictions where SEB conducts operations.